

Tax Subsidies
to Help Low-Income Families
Pay for Child Care

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Contents

Tax Treatment of Child Care	1
How Should Child Care Be Taxed?.....	3
Effectiveness of Current Child Care Subsidies.....	4
Improving the Child Care Credit	6
Options for Reforming the CDCTC	7
Other Options to Help Low-Income Families	10
Expanding and Simplifying the Child Tax Credit.....	10
Options for EITC Reform.....	12
Conclusion	14
References.....	15
Figures and Tables	17

Tax Subsidies to Help Low-Income Families Pay for Child Care

Low-income working families face enormous challenges. Key among them is how to pay for decent child care that would allow a parent to work. This issue is especially critical for single parents who must work outside the home to survive.

The federal income tax code subsidizes child care in several ways. The largest subsidy is the Child and Dependent Care Tax Credit (CDCTC), a nonrefundable tax credit of up to 35 percent of working parents' child care costs, subject to limits. However, many low-income families cannot benefit from the credit because they have no income tax liability to offset, making the credit worthless. Even for those with tax liability, the credit rate declines rapidly with income; most families receive a smaller 20 percent credit.

Though not earmarked specifically for child care, other tax subsidies provide more help to low-income working families. The Earned Income Tax Credit (EITC) is refundable—making it valuable even to families with little or no tax liability—and increases with family size (up to two children). Similarly, the Child Tax Credit (CTC) increases with family size and is partially refundable. In 2005, families with earnings over \$11,000 can receive a benefit even if they have no tax liability.

This paper considers options to reform the CDCTC to increase its value to low-income families and deal with some of its structural flaws—most notably the fact that its value declines over time because its parameters are not indexed for inflation. The paper also examines expansions to the refundable tax credits that help families with children.

The first section of the paper summarizes the tax treatment of child care under current law. The second section evaluates how child care should be taxed in an ideal tax system. The next section evaluates the effectiveness of current child care subsidies measured against those criteria, and discusses the effectiveness of recent expansions to the CDCTC. The fourth section examines options to reform the credit, while a fifth section examines expansions to the CTC and EITC as alternative options. The final section presents conclusions.

Tax Treatment of Child Care

The federal income tax code includes child care subsidies for both employers and employees. The largest subsidy comes from the CDCTC, worth about \$2.8 billion in FY 2006 (table 1). The CDCTC provides a nonrefundable tax credit to offset the expenses of providing care for either a child under the age of 13 or a disabled dependent while a parent or caretaker works or looks for work. Enacted as part of the Tax Reform Act of 1976, the credit was increased and made more progressive by the Tax Reform Act of 1986 and the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Currently, eligible expenses are limited to the lesser of \$3,000 per child (up to \$6,000 for

a household) or the earnings of the lesser-earning spouse. The maximum is reduced by any tax-free child care benefits paid by an employer.

Although the credit rate is 35 percent for taxpayers with incomes below \$15,000, the rate phases down to 20 percent for those with incomes over \$43,000. The credit rate does not vary with marital status, meaning some couples can face marriage penalties (that is, qualify for a lower credit rate) when they marry and combine incomes.¹ In theory, a low-income family with two or more children could qualify for a credit as high as \$2,100. However, because the credit cannot exceed tax liability and most families with such low incomes owe little or no income tax, the theoretical maximum rarely applies in practice. For higher-income households (adjusted gross income [AGI] above \$43,000), the maximum credit is \$1,200 for a family with two or more children and \$600 for those with one child.² Neither the maximum expenses eligible for the credit nor the phaseout thresholds are indexed for inflation, so the real value of the credit declines over time, especially for lower-income households. A temporary provision allows taxpayers to use the CDCTC (and other personal nonrefundable credits) against the AMT, but it is scheduled to expire after 2005. If it is not extended, growing numbers of middle-class families will not be able to use the credit over time (Burman, Gale, and Rohaly 2003).

The temporary expansions to the CDCTC in EGTRRA expire at the end of 2010. After that, the maximum individual credit rate will revert to 30 percent and the maximum allowable expenses will be reduced to \$2,400 for one-child returns and \$4,800 for returns with two or more children.

The federal income tax code includes two smaller subsidies directed toward employers. Employer contributions toward child and dependent care benefits (including those provided through a cafeteria plan at the election of the employee) are tax-free fringe benefits, excluded from both income and payroll tax. The exclusion is limited to \$5,000 per family per year, regardless of the number of dependents covered. The employer exclusion is worth about \$810 million in 2006.

In addition, employers may claim a tax credit for up to 25 percent of “qualified child care expenditures” and up to 10 percent of “qualified child care resource and referral expenditures.” Qualified child care expenditures include the costs of acquiring, constructing, and rehabilitating child care facilities for the benefit of employees; the operating costs of such facilities; or expenses incurred under contract with a qualified child care facility to provide child care services to employees. The services must be provided to employees in a nondiscriminatory way, and the facility must remain in service for at least 10 years. The total credit an employer may claim is limited to \$150,000 a year, and is worth about \$10 million in 2006. Enacted as part of EGTRRA, the provision expires after 2010.

¹ Most credits are claimed by married couples who file joint returns or single parents who file as heads of household. Custodial parents who file as single or married filing separately may also claim the credit, subject to limits.

² In addition, 27 states provide income tax credits or deductions for child care. See Donahue and Campbell (2002).

How Should Child Care Be Taxed?

Absent special considerations, the tax treatment of child care should be neutral. That is, it should not alter the choice of whether to provide care at home or away from home. It should not distort choices about the amount of time or money spent on child care, and it should not cause individuals to favor one child care supplier (such as an employer) over another.

Neutral tax treatment would most closely parallel the employer exclusion for child care benefits (Steuerle 1998).³ This is neutral because the same treatment applies to household production. If a parent invests \$5,000 of time to care for his or her children, rather than working outside the home for a salary, that parent saves the income and payroll taxes that would otherwise apply to those earnings. If instead the parent works outside the home and takes \$5,000 of earnings to pay for child care, those payments should be excluded from the parent's income; otherwise, the tax system is providing an artificial incentive for the parent to stay home and provide child care him- or herself.

Of course, special considerations abound. Society may have a paternalistic interest in protecting children, who cannot care for themselves, if their parents cannot or will not make the "right" decisions on their behalf. Society may, for example, want to encourage parents to care for their children at home. Or society may decide that low-income single parents should work outside the home, even if they have children who are too young to care for themselves. Indeed, based on the work requirements in the 1995 welfare reform legislation, it is reasonable to conclude that the latter is society's collective judgment.

In addition, the tax system itself may provide a reason to subsidize child care—that is, go beyond mere neutrality. Taxes penalize work outside the home, and subsidize leisure and work performed at home, which are tax-free. The penalties are most pronounced for high-income households, because they face relatively high marginal income tax rates, and lower-income households, because they may lose part or all of their earned income tax credit if a second earner works outside the home.⁴

Subsidizing child care for those who work may be justified as an offset to the anti-work bias created in the tax system. That bias may be deemed not particularly important, or even desirable, for parents with higher incomes—either because their labor supply is judged insensitive to tax penalties or because having a parent care for his or her own children is deemed socially valuable. But, as noted, current welfare rules dictate that low-income single parents work outside the home. A subsidy for child care complements that policy goal.

³ From 1954 to 1975, taxpayers who chose to itemize deductions were allowed to deduct child care costs (Maloy 2000).

⁴ The earned income tax credit phases out with income at rates of up to 21.06 percent for a family with two or more children. Secondary earnings are more sensitive to such work disincentives (Ellwood 2000). Note that EGTRRA increased the income level at which the EITC starts to phase out for married couples in order to reduce this bias.

High-quality child care is expensive and outside the reach of many lower-income families. In 1998, average annual child care costs per family ranged from \$3,000 to \$13,000, depending on region, type of care, and age of children (Schulman 2000). High-quality child care can cost much more than these averages. Although the cost of care does not appear to have a large effect on employment, it does have a significant effect on the type of child care arrangement chosen (Ribar 1995). Low-income working parents may be forced by high child care costs to rely on unsafe or inadequate child care arrangements, to the detriment of their children.

Poor-quality child care can result in young children missing opportunities essential to the development of healthy intellectual and social capabilities (Carnegie Corporation of New York 1994). And although money cannot guarantee high-quality child care, many aspects of high-quality child care, such as high teacher-to-student ratios, are expensive (Giannarelli, Adelman, and Schmidt 2003). As a result, subsidizing child care may be necessary to protect children in lower-income families and may contribute to economic mobility.

Effectiveness of Current Child Care Subsidies

The strongest policy argument for subsidies applies to low-income working families, but the CDCTC as currently structured provides them the least help. The CDCTC is nonrefundable, which means that households only benefit to the extent that they have tax liability. Almost 40 percent of households have no income tax liability after nonrefundable tax credits, and thus receive little or no benefit from the CDCTC.

In theory, the CDCTC is highly progressive. As noted, the credit rate is highest for those with very low incomes. In fact, though, the actual credit is regressive—it is worth least to those with low incomes. In 2005, a single parent with two children whose income came exclusively from earnings could receive no benefit from the credit until her income exceeded \$21,360 (figure 1). Assuming she has the maximum allowable expenses (\$6,000 for two children), the credit would increase in value between incomes of \$21,360 and \$33,000, and then start to decline with income as the credit rate phases down. But the theoretical maximum credit rate of 35 percent never applies. The highest effective credit rate for this family is 31 percent.⁵

Figure 1 also shows that the CDCTC increases enacted in 2001 amounted to less than advertised. In fact, since the increase in the child tax credit and the reduction in the lowest marginal tax bracket raised the tax entry threshold, many families stood to gain less from the CDCTC after the expansion than they received before. To be clear, their income tax liability did not increase, but the aid conveyed by the CDCTC vanished.

⁵ The maximum effective rate is higher for a head of household with one child, since that family would have one less personal exemption and thus owe income tax at lower income levels. Conversely, the maximum effective credit for a couple that files as married filing joint would be lower because the couple qualifies for both a higher standard deduction and an additional exemption (for the spouse). The couple thus starts owing income tax at a higher income.

For most families, the major benefit of the 2001 changes was the increase in expenditures eligible for the CDCTC, from \$2,400 to \$3,000 per child, that went into effect in 2003. However, that benefit is worth most to higher-income households because they are most likely to be able to afford to pay \$3,000 or more per child for child care (Barsimantov and Giannarelli 2000). As a result, the average credit is worth nothing for households with incomes under \$10,000, and twice as much for households with incomes between \$20,000 and \$30,000 as it is for households with incomes between \$10,000 and \$20,000 (table 2, current law). It increases somewhat more for households with higher incomes. Overall, we estimate that about 6.3 million households will benefit from the credit in 2005.

As noted, the EGTRRA expansions did not make the credit more progressive. The changes were worth nothing to the lowest income quintile of tax units, who cannot use the credit, and only one dollar on average to people in the second quintile (figure 2). The biggest winners were middle-income households, which averaged a \$7 tax cut, more than one-quarter of their pre-EGTRRA tax benefit. The low average tax cuts are a function of few people taking the CDCTC. For the 4 percent of middle-income households who could use the credit, the average tax cut was much larger—about \$170 per return. After all the changes, the bottom 40 percent of households receives only about 4 percent of the tax benefits. The highest-income 40 percent claims 72 percent of the subsidy.

Thus, the credit is poorly targeted.⁶ The failure to index the CDCTC for inflation will make matters worse over time. First of all, the nominal value of expenses eligible for the credit declines in real value over time. We estimate that by 2009, inflation will have eroded the entire increase in the maximum amount of expenses eligible for the credit.⁷ Second, since the income tax is indexed for inflation and the CDCTC credit phaseout is not, the higher credit rates will apply to fewer households over time because the tax filing threshold will increase in nominal terms. Third, the fact that the threshold for refundability of the child tax credit is indexed for inflation means that the nonrefundable credit tends to grow over time for a given nominal income level.⁸ This means that more people with incomes below the fixed nominal thresholds for the higher rates will have enough nonrefundable child tax credits to zero out their tax liability (and thus receive no residual benefit from the CDCTC).

Several issues arise when providing assistance to low-income households through the tax system. Tax subsidies can be very effective because most low-income working households already file income tax returns in order to claim tax refunds and the

⁶ States often have much more targeted subsidies for child care. Several states apply a modified child care credit only for people below a certain income level. Some states also make the credit refundable. A few states, however, allow only a child care expenses deduction, which can be even less progressive than a nonrefundable credit.

⁷ That is, \$3,000 in 2009 is roughly equivalent to \$2,400 in 2001, after adjusting for inflation.

⁸ The refundable portion of the child tax credit equals 15 percent of the excess of earnings over a threshold, currently set at \$11,000, up to the full credit amount. The threshold is indexed for inflation, whereas the statutory credit amount is not indexed (it is set at \$1,000 per child). Thus, for a given nominal income, the refundable credit will tend to decline and the nonrefundable credit will increase.

refundable EITC (Holtzblatt and McCubbin 2004). However, many low-income households are cash-constrained. For them, a tax credit may come too late to help pay for quality child care. Tax returns are filed months, and sometimes a year or more, after expenses are incurred. Although households that owe income tax can adjust their withholding to increase their take-home pay by the amount of anticipated tax credits, few choose to do that. As a result, the higher tax refund associated with the CDCTC may simply seem a windfall for many households, and one they would spend much differently than they would a direct child care subsidy.

Direct cash assistance for child care has several advantages. First, it can directly reduce the cost of child care when the expenditures are incurred. Second, the agency administering a child care grant or voucher can monitor the quality of the care provided to help insure that the best interests of the child are served.

Direct assistance programs also contain pitfalls. Fewer eligible people may use a direct assistance program than a tax credit because of welfare stigma or because the application and recertification processes inherent in a direct assistance program are difficult for working families to handle. For example, welfare office hours typically coincide with normal working hours, and low-income people often lack the flexibility to take off from their jobs to wait in line for benefits (Adams, Snyder, and Sandfort 2002).

A more critical limitation is that it is politically very difficult to adequately fund child care assistance programs at this time. The questions of whether to expand or decrease state-federal subsidies for child care and by how much were among the most contentious issues in the welfare reauthorization debate during the 2003 legislative session (Parrot et al. 2003). After large increases in funding post welfare reform in the late 1990s, current levels of federal and state funding are stagnating or even declining (Edie 2005). Tightening state budgets and reductions in the amount of TANF funds available to pay for child care have already forced states to reduce spending on child care programs, despite the fact that many states had long waiting lists for assistance (Schulman 2000). A study of 16 states found that between 75 and 90 percent of the families that qualified for subsidies under the federal income limits—income less than 85 percent of state median—were not being served (Adams and Rohacek 2002). As states face future challenges including growing education and Medicaid costs, child care subsidies may be cut back still further. Offsetting that trend, however, is the 2001 tax act, which expanded the CDCTC—raising the credit rates for lower-income households and raising the maximum eligible expenditures. Thus, tax credits seem a politically more viable option to expand child care assistance although refundable tax credits may be politically contentious as well.

Improving the Child Care Credit

Two changes could make the CDCTC more useful to low-income families: making it refundable and indexing it for inflation. If the CDCTC were refundable, eligible families would receive the full credit even if they had no tax liability. The EITC and a portion of the child tax credit are currently refundable, and other refundable tax credits have been

proposed. Critics of refundable tax credits argue that they become a form of welfare, rather than an aspect of determining tax liability; that refundability invites fraud and abuse; and that refundable credits add to the administrative burdens of the IRS. The first critique, while technically correct, is not specific to the issue of refundability. Tax credits, whether refundable or not, are simply spending programs administered by the IRS. If the expense that yields the credit were deemed a reduction in ability to pay tax, it should properly be administered as a deduction, rather than a credit. The whole point of employing the tax credit mechanism rather than a deduction is to provide a subsidy that is *not* tied directly to tax liability. The difference between refundable and nonrefundable credits is that nonrefundable tax credits are reduced or eliminated for those with the lowest incomes—which seems a questionable design in this case where poor children need assistance most.

The second criticism has little merit. There is no more (or less) incentive to claim a \$1,000 refundable tax credit fraudulently than a nonrefundable one (assuming that the taxpayer has at least \$1,000 in tax liability in the second case).⁹ This problem is best addressed by making eligibility criteria simple, clear, and verifiable. Fraud can also be deterred by requiring credit claimants to report a taxpayer identification number for child care providers (as has been done since 1989).

The third critique is apt for some refundable credit proposals, but not this one. A problem can arise if people are filing tax returns solely for the purpose of claiming a refundable tax credit. However, as noted, almost all households eligible for this credit would be filing tax returns for other reasons. Thus, it should be no more difficult for the IRS to handle returns claiming refundable credits than it is to administer the existing nonrefundable credit.

Options for Reforming the CDCTC

The errant targeting of the CDCTC could largely be corrected by making it refundable. If it were refundable, about 1.5 million more households could receive the credit in 2005 (table 2). In total, about 7.9 million people would receive an average credit of \$629. Because almost all families with incomes greater than \$40,000 are eligible to receive the full CDCTC under current law, they experience no change if the credit is made refundable. Only families that are unable to take advantage of their full CDCTC benefit from the credit becoming refundable. The largest benefits of making the credit refundable accrue to those in the lowest income categories because they are least able to take advantage of the CDCTC under its current structure. Tax units with incomes under \$20,000 (31 percent of the population) would receive almost 26 percent of the tax benefits, compared with less than 1 percent under current law.

⁹ It has been argued that low-income people may have a greater incentive to claim credits erroneously because the IRS has less recourse to reclaim a misbegotten credit since low-income people have few assets that can be placed at risk. Given the IRS's reluctance to seize assets in recent years, this argument also would seem to have little force.

We estimate that if people did not change their behavior to either begin purchasing child care or purchase more expensive child care, 544,000 people with incomes below \$10,000 would receive an average credit of \$704. This credit could provide a significant amount of help for low-income families struggling to make ends meet. Families with incomes between \$10,000 and \$20,000 that pay for child care would receive the largest benefit (averaging \$911), since they pay more for care than the lowest-income group. Nonetheless, such families would be less likely than average to claim the credit. Only 3.7 percent would get the credit, compared with 5.4 percent for all tax units. But that would still be a significant boost compared with current law, under which only 0.2 percent of tax units in this income range could benefit from the credit.

The Tax Policy Center estimates that making the CDCTC refundable would add \$1.6 billion on balance to its cost in calendar year 2005 (Option 4 in table 3). By comparison, the CDCTC reduces revenues by about \$3.2 billion in 2005, so adding refundability would increase the cost by half. The revenue cost would be greater if the option caused low-income households to spend more on child care.

If the temporary provision allowing taxpayers to use personal credits against the AMT is not extended, millions of upper-middle-income households will lose all or part of their CDCTC starting in 2006. Over time, more and more middle-income families would lose access to the credit. By 2015 (the end of the 10-year budget window), most middle-income families with children will be subject to the AMT and thus ineligible for the credit. In consequence, less than 4 million families would benefit from the tax credit, compared with 7.2 million if the credit is allowed against the AMT. Allowing the CDCTC against the AMT would reduce tax revenues by about \$14 billion over the 10-year budget period (Option 1 in table 3). Since the provision allowing the use of nonrefundable tax credits (including other popular tax subsidies such as the education tax credits) against the AMT has been extended every time it expired, this option is highly likely to be adopted.¹⁰

Option 2 would extend the higher credit amount and credit rates enacted in 2001 past their scheduled expiration in 2010. Without the AMT change and extension of the CDCTC changes, the amount of credits claimed would be reduced by more than 60 percent by 2015 (table 4). Although taxpayers at every income level would benefit from these changes, the majority of the tax savings would go to those with incomes between \$50,000 and \$200,000 since most of them would otherwise be ineligible due to the AMT. Note that, of the \$16.2 billion of revenue loss attributed to Option 2, only \$2.1 billion is due to extending the CDCTC provisions past 2010 (table 3).

The second major element of CDCTC reform would be to index its parameters for inflation. Indexation would prevent the real value of the credit from eroding over time, especially for those with low incomes. Indexation has been the norm for many income tax provisions since the early 1980s when tax brackets, the personal exemption, and the

¹⁰ Note that the cost of this provision would be significantly greater if the 2001–04 tax cuts are extended beyond their scheduled expiration in 2010. In that case, twice as many taxpayers would be subject to the AMT in 2011 and beyond, increasing the cost of AMT relief.

standard deduction were indexed for inflation to prevent “bracket creep,” the phenomenon whereby inflation raises taxpayers’ nominal income and thus pushes them into higher tax brackets, even though their real incomes have not changed. In the case of the CDCTC, the lack of indexing means that more households receive the lowest credit rate (20 percent) and that the value of the maximum credit amount (\$3,000) erodes with inflation. Under current law, where the CDCTC is neither refundable nor indexed for inflation, 78 percent of tax units would get the lowest credit rate in 2015 (96 percent of married filing joint returns), while no one would qualify for the maximum 35 percent rate (figure 3).

Indexation would dampen that trend somewhat.¹¹ The major gain from indexing arises from adjusting the maximum credit for price level changes. If indexed, the average credit would be \$91 higher than the credit in Option 2 (table 5). In addition, the average credit rate would increase slightly, benefiting some lower-income households. Overall, the largest increases in average credits accrue to those with incomes between \$20,000 and \$40,000 (in 2005 dollars).

As in 2005, the only way to extend the benefits of the CDCTC to low-income working people in 2015 would be to make it refundable. As figure 3 illustrates, over 16 percent of households claiming a CDCTC would qualify for the maximum 35 percent credit rate if not constrained by tax liability. The changes for low-income households would be dramatic. About 1.8 million nontaxable households with incomes below \$30,000 would qualify for a credit. The average credit would increase by almost \$900 for people with incomes under \$20,000 (table 6).

In combination, all the changes in Option 4 (allow credit against AMT, extend CDCTC increases past 2010, index for inflation, and make refundable) would help households at all income levels. But the changes would help those earning under \$20,000 the most; they would get 35 percent of the benefits even though they amount to only about 25 percent of the population. And the changes would be most significant relative to income for that group—worth 0.5 percent of income on average for those with income under \$10,000. Overall, the expansions would average 0.1 percent of income (table 7).

Options 5 and 6 would increase the maximum credit rate to 50 percent, in addition to the reforms in Option 4. Option 5 would phase out the credit starting at an AGI of \$15,000 at a rate of 1 percentage point per \$2,000 of income until the credit rate reaches the minimum 20 percent. This is the same phaseout scheme used under current law, but since the maximum credit rate is 15 percentage points higher, higher credit rates apply up to an income of \$73,000, compared with \$43,000 under current law. Under the second option, the credit would start to phase out at a higher income, but the phaseout rate would be faster. The credit rate would start to decline at an AGI of \$30,000 at a rate of 1 percentage point per \$1,000 of income. This proposal is similar to one made by the Clinton administration in 2000.

¹¹ Indexation would not stop the trend because real incomes are expected to grow over time.

As shown in table 3, these two options would reduce tax revenues by about the same amount over the 10-year budget window—\$57 billion for Option 5 and \$59 billion for Option 6. However, Option 5 is less well targeted. More than 12 percent of the benefits of Option 5 go to households with incomes over \$50,000, compared with 7.4 percent of the benefits of Option 6 (table 8). Households with incomes between \$10,000 and \$50,000 get larger tax credits on average under Option 6; households with incomes between \$50,000 and \$100,000 do better under Option 5.

Aside from the difference in distribution of tax benefits, the two different phaseout schemes can have different effects on incentives to work and save. The faster phaseout of Option 6 means that some taxpayers with AGI over \$30,000 could lose up to \$60 of tax credits for every \$1,000 of additional income earned.¹² Effectively, the faster phaseout creates an implicit surtax on income at a rate as high as 6 percent for taxpayers with incomes in the phaseout range. By comparison, the maximum surtax would be half as much—3 percent—under Option 5 because of the slower phaseout rate. But, since the phaseout does not start until a higher income level, Option 6 spares everyone with incomes under \$30,000 from the implicit surtax. Since those households tend to face high effective marginal tax rates from the phaseout of the EITC (and, in some cases, eligibility for cash transfer programs such as food stamps), Option 6 might be preferable in the context of the whole tax and transfer system.

Other Options to Help Low-Income Families

Another approach to helping low-income households meet their child care needs would be to increase their income through an expansion of the refundable EITC or CTC. An advantage of this approach is that it is neutral with respect to how working families meet their child care needs. It also does not require creation of a new refundable tax credit to help low-income households, and it is highly targeted. The main disadvantage is that the EITC has been under assault lately from those who complain it is prone to high error rates and is tantamount to welfare run through the tax system. For these reasons, significant EITC expansions (and expansions in other refundable credits) may be politically infeasible. In addition, this option offers no direct incentive to pay for better child care.

Expanding and Simplifying the Child Tax Credit

Currently, households are allowed to claim a partially refundable child tax credit for each qualifying child under age 17 in a household. The child tax credit is equal to \$1,000 per child. The credit starts to phase out at adjusted gross incomes over \$110,000. Low-income households may claim a refundable CTC of up to 15 percent of earnings in excess of \$11,000 in 2005. Thus, a household with earnings of \$12,000 may claim a refund of up to \$150 (15 percent of \$1,000) if they have at least one qualifying child. If EGTRRA is

¹² The credit phases out at a rate of 1 percentage point per \$1,000 of AGI. One percent of the maximum child care expenses allowed (\$6,000 for two or more children) is \$60.

not extended, the CTC will return to \$500 per child after 2010 and the new refundability rules will expire.¹³

The 2003 legislation that expanded the CTC also made the definition of child more uniform. Before 2003, the same child could be deemed eligible for some tax provisions but not others. The 2003 reforms simplified and conformed those provisions so that, in most cases, children under the age of 13 who could be claimed for one tax benefit could also be claimed for others. However, the law left in place different age limits for eligibility for different benefits. As a result, a child age 15 might qualify for a dependent exemption, EITC, and CTC, but not CDCTC. A child age 20 who is a full-time student could still qualify for the EITC and dependent personal exemption, but not the other credits.

One possibility would be to set the same age limits for all these credits—generally up to age 18 for child dependents and up to age 23 for children who are full-time students. Although this would be a simplification, it would raise issues in the case of the CDCTC. Children age 13 and over are generally thought old enough to serve as caregivers, so defining legitimate child care activities without opening avenues for abuse¹⁴ for this age group would be problematic.¹⁵

However, it would be a straightforward simplification to make the CTC available to all child dependents. This would effectively raise the age limit from 16 to 18 or 23 depending on student status.¹⁶ This option would reduce revenues substantially over the budget window. Including the cost of making the EGTRRA provisions permanent, revenues would decline by \$247 billion over 10 years (Option 2 in table 9). Most of that

¹³ A refundable child tax credit for certain families with three or more children predates EGTRRA and will continue past 2010. However, most low-income families receive a larger benefit from the EGTRRA provisions (Burman, Maag, and Rohaly 2002).

¹⁴ If qualifying child care expenses included care of teenagers, it would be easy (and legal) to abuse the system. A person could pay the teenager next door to care for his or her teenage child on Monday and Tuesday, the neighbor could pay the first person's teenage child to care for the neighbor's child on Thursdays and Fridays, and each household would qualify for a refundable credit. Each household would pay \$3,000 and would receive \$3,000 from the neighbor (so their net incomes would be zero), and would receive a \$1,500 refundable credit. The children would owe income and payroll taxes on some or all of the \$3,000 in babysitting income, but their tax would amount to less than half of the credit. The IRS could try to stem such schemes, but the neighbors could achieve the same result by playing round robin: neighbor 1 cares for neighbor 2 who cares for neighbor 3 who cares for neighbor 4 who cares for neighbor 1. (Probably most people wouldn't be so devious, but it is poor practice to create such incentives in the tax law.)

¹⁵ Chicago Mayor Richard Daley (2005) has floated the idea of allowing the CDCTC for older children as a way to encourage participation in after-school programs. Conceivably, this limited use of the credit could be defined in such a way that it could not be abused—for example, by requiring that program providers be certified by a state or local authority. However, since the nature of this program is very different from care provided to young children, it might make more sense to create a new subsidy program, either a cash grant to state and local governments that provide or sponsor these programs or a tax credit targeted directly at qualifying after-school programs.

¹⁶ The credit would also continue to be available in the limited cases where nondependent children are eligible under current law.

cost (\$134 billion) is attributable to extending the higher child tax credit and refundability beyond their scheduled expiration in 2010 (Option 1). In 2015, only about a quarter of the revenue loss is attributable to conforming the age thresholds.

In 2005, Option 2 provides 44 percent of its benefits to families with incomes between \$50,000 and \$100,000. Families with incomes below \$50,000 receive about 36 percent of the total benefits (table 10). This option is far less targeted than making the CDCTC refundable. Another more targeted alternative would be to expand the refundable EITC, which is discussed next.

Options for EITC Reform

The EITC is the largest cash assistance program for low-income families.¹⁷ The EITC provides up to \$4,400 a year (in 2005) for working families with two or more children, and smaller amounts for families with fewer children. For families with tax liability less than their EITC, the excess is rebated to them in the form of a tax refund.

There are three ranges for the EITC. In the phase-in range, the credit increases with earned income until reaching the maximum credit. Then, over a fixed range of earnings (the “plateau”), recipients receive the maximum credit. At higher earning levels, the credit phases out as earnings increase until it is eliminated. In 2005, the credit was fully phased out for single parents with two children once their earnings reached \$35,263. Married couples with two children could receive the EITC until their combined earnings reached \$37,263.

EGTRRA increased the point at which the EITC starts to phase out for married couples by \$3,000 in 2008 and indexed the threshold after that. (The increase was phased in using \$1,000 increments starting in 2002.) The first option for reforming the EITC (Option 3 in table 9) would make permanent the EGTRRA EITC provisions, which would otherwise expire after 2010. The option would continue to index the higher phaseout threshold for married couples after 2010.

The second option for reforming the EITC (Option 4 in table 9) would reduce the phaseout rates in order to extend the point at which the EITC is completely phased out by 10 percent in 2005.¹⁸ The third option for reforming the EITC (Option 5 in table 9) is identical to the second option for reforming the EITC but is limited to married couples.

The final option for reforming the EITC (Option 6 in table 9) would create a third tier of the EITC for families with three or more children. The option would increase the credit rate for three or more children—currently set at 40 percent—by 25 percent, which

¹⁷ Preliminary estimates of the 2002 nonadministrative costs of the EITC total \$38.7 billion (IRS 2004); the combined expenditure of state and federal funds on cash assistance in Temporary Assistance for Needy Families (TANF) totaled \$14.6 billion (HHS 2002).

¹⁸ In 2008, the phaseout point for the EITC is scheduled to increase for married couples by \$1,000. The phaseout rates for married couples would again be adjusted so that the credit phases out completely at a income level that is 10 percent higher than under current law.

